

Macro Weekly

US Growth Splutters

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The relatively strong momentum in the US economy over the last three years has been the locomotive driving overall global growth. President Trump's 2017 tax package super-charged US growth during 2018, but the latent impact of this stimulus appears to be fading. Real GDP growth in the US has declined from +3.5% to +2.0% over the past year, US equities have delivered flat returns in local currency terms, and most of the US yield curve is now inverted — strong signals of an impending recession. While consumption makes up 70% of US economic activity, industrial production and capex are important contributors, providing incomes and confidence to the broader economy. US monthly factory activity contracted in August for the first time since 2016, with a decline in new orders and employment. Prices also contracted for the third consecutive month, indicating lower overall systemic demand.

Wall Street slashing US GDP forecasts

The on-off nature of the trade war between the US and China has seen Wall Street banks holding off adjusting their GDP forecasts for the US economy. But now the latest round of tariffs have been implemented, bank forecasts for US growth are being cut for 2020 (election year). The latest round of tariffs is substantial and will hit the consumer particularly hard. The flow-on hit to the retail sector will have a direct consequence to business viability and payrolls data. The weak August manufacturing data validates the downward revision to industrial activity, especially as US exports have also collapsed. The export reading for August was 43.3, down from an expansion high of 62.8 in February 2018, and is the lowest reading since June 2009. Because tariffs work with lags, the latest round won't have much of an impact until Q1 2020. But growth could slow quite markedly from then, with estimates of annual growth falling to between +0.25%–0.50% by the middle of next year.

S&P 500 aggregate revenues, which rose only +2.9% year-on-year during Q2 2019, are highly correlated with the US Manufacturing PMI. On the latest reading and outlook, revenue growth could weaken further.

Weaker consumption will hit business investment

Business investment in the US has held up pretty well through the first half of 2019. However, additional tariffs on intermediate goods and new tariffs on consumer items will have a negative effect on investment spending. The one bright spot to date has been energy related capex with oil and gas output in the US hitting new highs. But if the broader economy slows, demand for oil will fall, which should have a flow-on hit to investment in the energy sector.

Zero funding poses risks to market stability

Despite many personal, government, and business balance sheets already being over-indebted, the lure of zero funding costs will continue to attract speculative scavengers to various sectors and industries. These market participants will continue to exert downward pressure on prices and undermine the profits of larger, more established businesses. This will increase the risk of defaults by the new entrants, and undermine incumbents, which may spark a credit crisis in some of the undercapitalised banking jurisdictions.

There are many unintended consequences of negative interest rates. But as Europe and Japan look to push even further into negative territory, one of the worst consequences is the messaging — that the economy is in trouble.

Slower US growth Outlook

US Factory Activity Contracts

The ISM Manufacturing PMI in the US fell to 49.1 in August 2019 from 51.2 in the previous month, missing market expectations of 51.1. The latest reading pointed to the first month of contraction (index below 50) in the manufacturing sector since January 2016 as new orders and employment declined.

The new order component plunged to 47.2, and the employment index dropped to 47.4. In addition, the production index fell to 49.5, and price deflation eased to 46.0.

Feedback from participants reflects a notable decrease in business confidence. Respondents also expressed more concern about US–China trade turbulence, but trade remains the most significant issue, indicated by the strong contraction in new export orders.

Figure 1. US ISM Manufacturing PMI Index



Source: Forsyth Barr analysis, Trading Economics

Europe, China and Japan's monetary stance pushing the USD higher

The 'race to the bottom' currency war that is underway by almost every country except the US at the moment is keeping upward pressure on the USD. This is exacerbating the decline in US export competitiveness and trade strength. The stronger USD is also contributing to tightening USD global liquidity and adding to the deflationary pressures now increasing around the world. The risk is, these deflationary pressures lead to a bust which then infects USD credit.

The Fed is now expected to cut rates in September but possibly not as much as the market is expecting. Any further reticence by the Fed governors to ease USD liquidity will likely see significantly higher volatility in financial market asset prices over the next few months.

Deflations drag

As growth and demand slows, households and businesses stop borrowing, despite collapsing interest rates. As credit growth slows, the multiplier impact in the economy also slows. Any slowdown in credit reflects a cut in investment. A retrenchment in investment results in a decline in liquidity in the financial system — forcing central banks into even more extreme measures.

The US already has a budget deficit approaching 4% of GDP. This is forecast to grow to 5% over the next year or so, excluding the possibility of a recession. With debt to GDP in excess of 106% and with budget deficits approaching US\$1.5 trillion, the issuance of USD debt is about to increase at a serious rate. Despite the USD trade weighted index hovering near 18-year highs, the flow of funds that will be required to fund the US deficits is likely to undermine attempts to weaken the USD in the near-term. This will remain a headwind for the global economy.

While the Fed only has 225bp of rates to play with before they have to go negative, other countries are in a worse position, hence, the currency wars already underway.

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